

## U.S. RECESSION POLICIES: NOTHING NEW UNDER THE (RISING) SUN

The current recession in the United States has much in common with Japan's recession of the 1990s. Although many of the microeconomic regulatory causes differ, both recessions were preceded by bubbles caused, at least in part, by expansionary monetary policy. Policymakers in both the U.S. and Japan have also chosen similar policies to combat the collapsing bubbles and resulting recessions. Those policies led to Japan's "lost decade" of growth. The United States could head down a similar path unless policies change.

The collapse of the housing bubble in the United States began with a slight decrease in housing prices in the third quarter of 2006. According to the Case-Shiller Index, national average home prices have declined by 32 percent from their high in 2006 through the first quarter of 2009. In some markets the downturn has been much more severe. Phoenix and Las Vegas housing prices have declined more than 50 percent, and many California and Florida markets have seen declines greater than 40 percent.<sup>1</sup> The decline in housing prices led to a spike in foreclosures. The resulting bad debt in the financial system led to a financial crisis and broader economic recession. The Dow Jones Industrial Average fell from a

high of over 14,000 in late 2007 to a low of just over 6,500 in early 2009; the Dow has since begun a slight recovery. The National Bureau of Economic Research dates the onset of the current recession from December 2007.<sup>2</sup> According to the Bureau of Economic Analysis the contraction of real GDP has been more dramatic recently. In the last quarter of 2008, GDP contracted at an annualized rate of 6.5 percent and at a rate of 5.5 percent in the first quarter of 2009.<sup>3</sup> The economic downturn has resulted in the unemployment rate reaching 9.5 percent as of June 2009.<sup>4</sup>

Japan had a housing bubble in the late 1980s until the early 1990s. When it collapsed, real estate prices fell 80 percent from 1991 through 1998.<sup>5</sup> The Nikkei stock market index also fell dramatically, from a high of approximately 40,000 in 1989 to less than 15,000 by 1992. It remained under 20,000 for most of the rest of the decade and eventually slipped under 10,000 in 2002. Broader economic activity slowed dramatically. GDP growth

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had averaged approximately 6 percent in the late 1980s until the crisis, and Japan had long maintained high growth rates. But with the collapse of the bubble, GDP growth shrank to 2.5 percent in 1992 and little more than 1 percent annually over the next three years. GDP growth was eventually negative from 1998 through 2000. Japan's unemployment rate more than doubled from a little over 2 percent to nearly 5 percent.

Japan in the late 1980s and the United States more recently each experienced real estate bubbles that collapsed along with stock market indices and broader measures of economic activity. Each bubble was fueled, in part, by expansionary monetary policy. Japan's initial collapse was followed by more than a decade of stagnation. To avoid similar stagnation in the United States, policy-makers should avoid repeating the mistakes the Japanese government made in dealing with their crisis.

In what follows, I briefly explain the U.S. and Japanese bubbles in the context of Austrian business cycle theory.<sup>6</sup> However, business cycle theory alone does not explain the length or severity of either recession. I will then explain the fundamental misdiagnosis of the problem by policymakers in the United States and Japan and how their recession "remedies" have prolonged the economic downturns. Finally, I will suggest some potential paths forward for the United States and how these paths might differ from Japan's experience.

## EXPANSIONARY MONETARY POLICY AND THE BIRTH OF THE BUBBLES

Many economists correctly identify easy monetary policy as a key contributing factor to the creation of the United State's housing bubble. From traditional monetarists like Anna Schwartz, to John Taylor, to Austrian economists like Mark Thornton and Tom Woods, among many others, all blame overly expansive monetary policy for enabling the housing bubble.<sup>7,8</sup>

Following the collapse of the "dotcom"

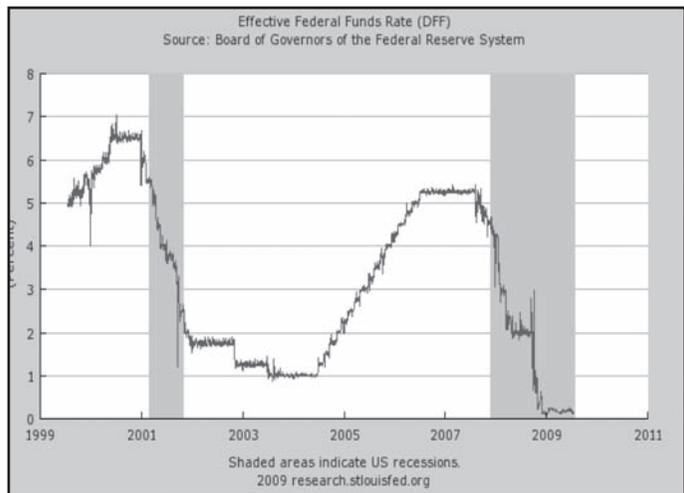


Fig. 1—Effective Federal Funds Rate

bubble and the 9/11 terrorist attacks, the Federal Reserve kept interest rates at extremely low levels. The Fed funds rate was lowered from over 6 percent to under 2 percent from 2001 to 2002 and then further lowered to 1 percent where it remained until late 2004 (See Figure 1). The housing bubble eventually burst once the Fed funds rate returned to over 5 percent.

Interest rates coordinate economic activity through time. Specifically, they signal people's time preferences, or in other words, their desire for current consumption versus future consumption. When the central bank intervenes by forcibly lower-

ing interest rates, it distorts the signal from savers to investors. Individuals, faced with a lower return on their savings, desire to save less and consume more. Meanwhile, investors and consumers of durable goods desire to purchase more long-term assets because the cost of financing those investments has decreased. Capital and labor in the economy are simultaneously bid into industries to satisfy current consumption and also to construct long-term capital investments and durable goods. Yet there are not enough real savings to complete all of these projects. When higher interest rates reassert themselves, unprofitable investments are revealed and must be liquidated. In the Austrian theory of the business cycle, the resulting recession is necessary to liquidate the prior malinvestments of the artificial bubble so that capital and labor can be reallocated to serve consumer preferences best.

Austrian business cycle theory predicts that those industries that are particularly long-term will be more interest rate-sensitive and more likely to over-expand during an artificial boom. Which particular industries over-expand depends on how the new money is injected into the economy and any number of microeconomic regulations. In the U.S. bubble there were a host of federal government policies that funneled the newly created money into commercial banks and then encouraged those banks to make housing loans. It is beyond the scope of this paper to document all of these policies, but important

ones include the implicit loan subsidy through Fannie Mae and Freddie Mac, the ramping up of the enforcement of the Community Reinvestment Act that encouraged banks to water down their lending standards in order to qualify more buyers, and government-regulated ratings agencies that failed to accurately assess the risks of the new loans.<sup>9</sup> As a result of the excess loanable funds in the banking

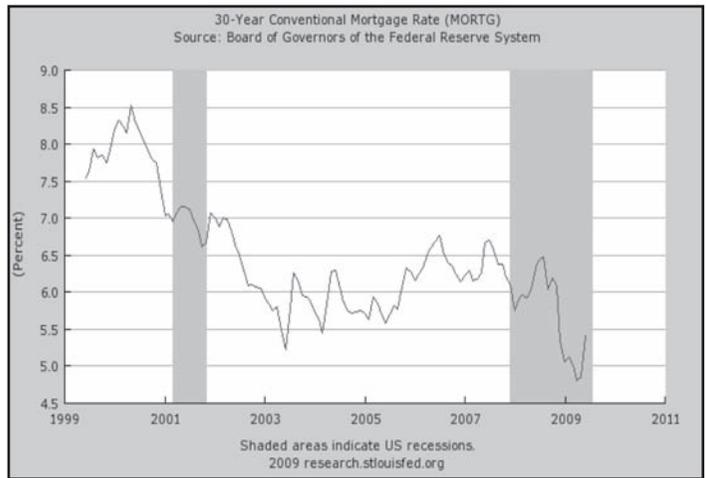


Fig. 2—30-Year Conventional Mortgage Rate

system and the regulatory push to lend to more home buyers, mortgage rates fell from 8.5 percent to under 5.5 percent during the bubble (See Figure 2). Meanwhile, a host of new mortgage products such as zero-money-down and no-income-verification mortgages were created.

The zero-money-down and no-income-verification loans eventually spread to borrowers who did not fall under Community Reinvestment Act guidelines. They became tools for speculators to leverage. Speculation was fueled by cheap credit (and easy access to it), rising housing prices, and many state laws that protect an individual's other assets from seizure if a housing loan is foreclosed on. This last condition essentially allowed speculators to win when prices went up, and to walk away with only their credit

rating damaged if prices went down and if they had a home they had bought with zero money down.

It is many of these microeconomic interventions that helped steer the excess credit creation from easy monetary policy into housing and related industries. Real estate investment was already at historically high levels in the 1990s, and it increased dramatically during the bubble (See Figure 3).

This is the situation that the current U.S. crisis confronts: a situation where real resources—capital and labor—were disproportionately bid into housing and related industries. For recovery to occur, those resources must be reallocated to other sectors of the economy.

What does the current U.S. situation share with Japan's in 1991? Many of the microeconomic interventions of the current boom are unique to the United States. However, both Japan in the late 1980s and the United States in the 2000s pursued easy monetary policy.

Following the Plaza Accord in 1985, Japan attempted to boost its export sector, which was struggling with a stronger yen, by easing monetary policy. The Bank of Japan discount rate that stood at 5 percent in 1985 was lowered to 3 percent in 1986 and then to 2.5 percent for 1987 and 1988; it remained below 5 percent until 1990. This helped fuel real estate and stock bubbles in Japan. Japanese real estate prices rose 51 percent from 1985 through early 1991.<sup>10</sup> At the peak of the bubble in early 1991 all the land in Japan was valued at approximately \$18 trillion—*four*

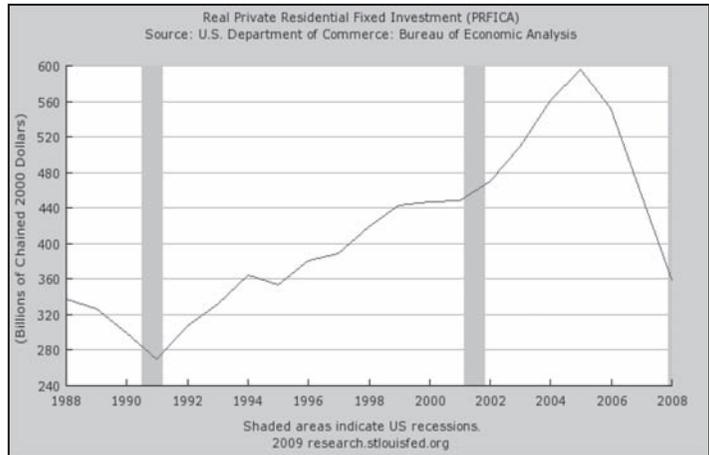


Fig. 3—Residential Fixed Investment

times the value of all the property in the United States at that time, despite the fact that Japan is approximately the size of California.<sup>11</sup> Like the current crisis in the United States, these prices came crashing down once the central bank stopped the expansionary monetary policy and allowed interest rates to rise.

#### U.S. AND JAPANESE RESPONSES TO THEIR CRASHES

In artificial bubble economies labor and capital get bid into the wrong industries because interest rate and price signals are distorted. The crucial role of prices in a market economy is to direct scarce labor and capital to those industries that best satisfy consumer desires without leaving any more important desire left unsatisfied. Injecting money into the economy through expansionary monetary policy distorts the interest rate price signal and other relative prices throughout an economy. The low interest rates fuel investment into long-term and capital-intensive projects. As money is injected into the housing industry, land and home prices are bid up and attract more capital and labor into construction, mortgage lending, real estate brokerage, construction equipment manufacturing, and other related indus-

tries. To recover from a bubble, the market must reallocate labor and capital from over-expanded bubble industries to other industries that better satisfy consumer desires. Allowing the price signal to express consumer desires is necessary for this readjustment process.

The longer an artificial bubble is maintained and the more distorted price signals become, the more capital and labor is misallocated. However, there is nothing in the Austrian theory of the business cycle that claims that the length or severity of a recession following a bubble must be proportional to the expansion. If market prices are allowed to function freely and capital and labor can be reallocated quickly, the losses from the bubble can be quickly revealed, and heterogeneous capital can be reallocated. Although there will be a loss of real resources, the economy may again begin growing from that point forward.

Policy makers in the United States and Japan have mistakenly tried to “stimulate” the aggregate economy as if there were a drop in aggregate demand. The problem, however, is not one of overall lack of demand by consumers for goods and services. Rather, the problem is a mismatch between consumers’ particular desires and what the productive structure of the economy is prepared to produce. Recovery comes when that productive structure evolves to match consumers’ particular desires. Unfortunately, by misdiagnosing the problem as one of aggregate demand, government efforts to stimulate the economy have hampered freely determined market prices from reasserting themselves and thus delayed the necessary adjustment to the structure of production. Japanese officials were particularly effective at delaying the adjustment to the structure of production.

The Japanese government passed fiscal stimulus bills early in their crisis. Between

1992 and 1995 the Japanese passed six different stimulus packages totaling 65 trillion yen. The average yearly stimulus amounted to a little more than 3 percent of the total Japanese economy. In 1998 two fiscal stimulus bills amounting to about 8.5 percent of the Japanese economy were passed. Again in 1999 an 18 trillion-yen fiscal stimulus was passed, and in 2000, another 11 trillion-yen bill was passed. Over the decade, ten fiscal stimulus bills totaling more than 100 trillion yen were passed.

These repeated fiscal stimulus packages delayed recovery by maintaining Japan’s existing—and distorted—structure of production. These packages were disproportionately directed to maintaining the construction industry. For instance, almost half of the 16.7 trillion-yen stimulus in April 2008 was spent on public works. Overall, between 1991 and 2000, the construction industry received over 59 trillion yen in orders from the government amounting to more than 30 percent of industry revenue. At the time the construction industry accounted for 7.6 percent of GDP and 9.7 percent of the labor force. As an Economist Intelligence Unit profile noted, “Generous public works programmes have allowed many unviable construction companies to remain in business.”<sup>12</sup> Fiscal stimulus packages that prop up unviable companies only delay the process of recovery by keeping scarce labor and capital in industries that do not match consumer desires.

Japan also continued to distort interest rate signals during the recession. From a high of 6 percent the Bank of Japan lowered its discount rate to 4.5 percent in 1991, 3.25 percent in 1992, 1.75 percent during 1993–94, and finally to 0.5 percent or less during 1995–2000. These low interest rates have also delayed the reorganization of the structure of production.

Furthermore, many attempts at expanding bank lending have only encouraged banks to hold excess reserves. When the Bank of Japan expanded the monetary base 10 percent from mid-1997 to mid-1998, broader measures of money expanded by only 3.5 percent. Japanese banks that had invested in real estate and stocks or made loans that were collateralized by real estate and stocks had a tremendous amount of bad debt on their books. The increased funds from the Bank of Japan were largely held as cash reserves against these bad loans.

The Japanese government's answers to the problems in the banking industry were bailout funds and nationalization. In late 1998, a \$514 billion bailout fund was established, with \$214 billion designated to buy stock in troubled banks, and \$154 billion to nationalize, restructure, and liquidate failed banks. Nationalization and bailout funds only serve to prop up unsound financial institutions, delaying the needed restructuring that would allow them to serve their function as financial intermediaries again. A free market deals with unsound banks through bank failures, mergers, acquisitions, and restructuring. After market-based corrections, banks would serve in their role as financial intermediaries again.

The Japanese government went to great lengths to prevent the liquidation of their boom's malinvestments. Japan set up a 20 trillion-yen credit guarantee fund to ease credit availability for companies. The Economist Intelligence Unit profile indicated that "funds disbursed under the programme are often going to companies that are not creditworthy and that would otherwise go bankrupt."<sup>13</sup> The Japanese government allocated many loans through a Fiscal Investment and Loan Program (FILP). FILP got its funding from the postal savings system, which had 254.9 trillion yen in funds at the end of 2000—

accounting for around 35 percent of total household deposits. Government lending was usually made to political allies of the Liberal Democratic Party, such as the construction industry, resulting in wasteful, loss-producing projects that did not reflect consumer preferences.

The United States government's response to the recent collapse of its housing bubble has mirrored many of Japan's policies, although the order of implementation has been reversed. Interest rates have been slashed, bailout funds have been given to banks and private companies, and a large fiscal stimulus bill has been passed. For all of the same reasons that these policies failed in Japan, they will not help recovery in the United States.

Interest rates were slashed, and bailouts were given to financial institutions in the federal government's initial response to the burst of the housing bubble. The Fed funds rate was slashed from more than 5 percent to nearly 0 percent. In addition to the Fed's provision of almost limitless liquidity, direct bailouts have been tried from the beginning. In 2008, J. P. Morgan was given a \$30 billion credit line from the government to take over Bear Stearns.<sup>14</sup> Fannie Mae and Freddie Mac were essentially nationalized, and the government's "implicit guarantee" of their debts became explicit. AIG has had four separate bailouts. The Troubled Asset Relief Program (TARP) was authorized to spend \$700 billion in October 2008 to bail out firms. Citigroup was bailed out to the tune of \$280 billion, and Bank of America was bailed out with \$142 billion, each of these partly with TARP money and partly through other government programs. Like Japan's FILP, direct government lending to non-financial institutions was also implemented. One instance of this is the major bailout that was provided to the American auto industry.

Each of these bailouts delayed the restructuring of banks with bad assets and lack of capitalization. The market process sorts out banking problems with mergers, takeovers, and bankruptcy. The government bailouts have slowed this process and delayed the ability of banks to return to functioning as efficient financial intermediaries. The interventions have also clouded the ability of the market to evaluate companies: the uncertainty about who is going to get the next bailout makes it hard for the market to assess a company's value and thus further delays its process of correction.

American policymakers, like their Japanese counterparts more than a decade ago, have also mistaken the economic downturn for a lack of aggregate demand. The Obama administration passed a nearly \$800 billion fiscal stimulus bill in early 2009 that amounts to nearly 6 percent of the total U.S. economy. It, too, emphasizes public works construction that will delay the reallocation of capital and labor out of that industry, but it also includes a host of other spending programs that have little to do with either the bubble or recovery. The bill's net effect is to burden private business with the prospect of future tax increases while favoring politically connected industries with revenue today.

#### DIVERGENT PATHS FORWARD?

In response to the collapse of the housing bubbles in Japan in the early 1990s and the United States in the late 2000s, both governments slashed interest rates, bailed out financial firms, and passed fiscal stimulus bills. The result in Japan was a decade of lost growth. There are several differences between the American situation and Japan's that should be cause for optimism in the United States.

Casual observation suggests that the United States' economy is more dynamic

and adaptable to change than is Japan's. In both cases, the structure of production was distorted during an asset price bubble. The key for recovery is to allow the structure of production to readjust during the recession. This means layoffs and business closures. Japan had a cultural tradition of lifetime employment that made it difficult for firms to lay off unnecessary workers. In fact, in 1995 unemployment still stood under 3 percent, and it never rose above 5 percent at any time in the decade. The sharp increase in unemployment in the United States is a sign that over-expanded industries are shedding workers who can be better employed elsewhere. Reemployment takes time, and policies like unemployment insurance and a generally unfavorable business climate delay the labor reallocation process, but at least the process seems to be underway in the United States despite government efforts to prop up failing firms.

Capital may also be reallocated more slowly in Japan than in the United States because of the proportion of savings managed by the government. As mentioned above, about 35 percent of total household deposits are in the postal savings system, which is invested by government officials through FILP. In the United States, private flows of savings and capital investment play a greater role and should be more responsive to changing market conditions that will allow for a more rapid adjustment of the structure of production, despite interventions. This is not to say that the U.S. government's interventions in response to the collapse of the bubble have not slowed the necessary process of adjustment. It just means that the U.S. economy is more resilient (despite government intervention) in its reallocation of capital and labor than Japan's economy.

Another reason for optimism in the United States is that it is unlikely that U.S.

policymakers will be able to maintain the level of fiscal and monetary intervention that Japan's policymakers maintained for a decade. All of the Japanese interventions pushed their on-budget government debt to over 100 percent of GDP; by some estimates, total debt, which includes off-budget items like bad investments in the FILP, amounted to over 200 percent of GDP. As of July 2009, the U.S. government had already accumulated approximately \$11.5 trillion in debt. In an approximately \$14 trillion economy, this level of debt results in a debt-to-GDP ratio of more than 82 percent. The White House's own budget forecasts over the next decade call for approximately \$9 trillion of additional debt. It seems unlikely—given the size of the U.S. economy, its accumulated debt, projected deficits, and the fact that world GDP is only around \$60 trillion—that there will be enough foreign savings to finance a decade of large fiscal stimulus interventions proportional to Japan's in the 1990s.

Thus far the U.S. response to the collapse in the housing bubble has had much in common with Japan's response to its bubble collapse in the 1990s. As a result, recovery has been delayed. So far, however, these interventions have not achieved the scale that Japan's did and if further interventions are not pursued, there is reason to be optimistic about recovery in the United States.

### CONCLUSION

This paper has not attempted to explain in fine detail all of the factors contributing to the U.S. housing and financial crisis. My own view is that the magnitude of the current crisis is best explained by a “perfect storm” composed of excessive monetary expansion, microeconomic regulation of housing that encouraged the funneling of excess credit into housing and encouraged

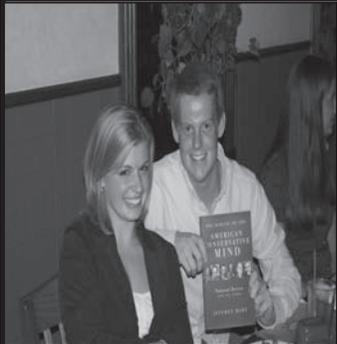
lenders to lower standards, regulatory protection that encouraged excessive speculation by privatizing rewards and socializing risks, and supply-side restrictions that contributed to inflated prices. While all of these factors contributed to the crisis, the main story of the unfolding recession is yet to be told. Much of the length and severity of a recession can be explained not by the bubble that preceded it but by the detrimental policies adopted by government in response to the downturn. These interventions create what economists call “regime uncertainty,” in which economic actors are paralyzed in the face of uncertainty about what the institutional environment will be, and by straightforward “regime worsening.” This can take the form of government's consumption of a higher percentage of GDP, the expectation of future tax increases or inflation, or an increase in regulation. Clearly both regime uncertainty and regime worsening have been created by the Bush/Obama interventions. The scope and frequency of these interventions in the future will determine the length and severity of this recession.

This study's main contribution is to highlight some of the broad common elements in the U.S. bubble and the policy response to it and in Japan's mid-1980s bubble and 1990s recession. Both had real estate bubbles inflated by excessive monetary creation. In both cases, too many resources were bid into housing and related industries. Both governments responded by lowering interest rates, bailing out troubled firms, and passing large fiscal stimulus packages. In both cases these interventions delayed economic recovery by slowing the reallocation of labor and capital from over-expanded bubble industries to ones better aligned with consumer preferences. Hopefully, American policymakers will not be as successful as their

Japanese counterparts were at delaying this reallocation.

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- 5 The sections of this article that describe the bubble and recession in Japan draw heavily on Benjamin Powell, "Explaining Japan's Recession," *Quarterly Journal of Austrian Economics* 5, no. 2 (Summer 2002): 35–50. All Japanese statistics are drawn from this article unless otherwise cited.
- 6 It is beyond the scope of this paper to give a full account of Austrian business cycle theory (ABCT). Roger Garrison's *Time and Money* (Routledge, 2000) is an excellent modern statement of the theory for readers who are unfamiliar with ABCT.
- 7 Brian M. Carney, "Bernanke is Fighting the Last War," interview with Anna Schwartz, *Wall Street Journal*, October 18–19, 2008; John Taylor, *Getting Off Track* (Palo Alto, CA: Hoover Institution Press, 2009); Mark Thornton, "The Economics of Housing Bubbles," in *Housing America: Building Out of a Crisis*, ed. Randall Holcombe and Benjamin Powell (Piscataway, NJ: Transaction, 2009); and Thomas E. Woods Jr., *Meltdown* (Washington, D.C.: Regnery, 2009).
- 8 An alternative view is that increased world savings pushed interest rates down. See Jeffery Rogers Hummel and David R. Henderson, "Did Greenspan Cause the Housing Bubble?" *Forbes*, April 17, 2009. [www.forbes.com/2009/04/17/greenspan-housing-bubble-opinions-contributors-fed.html](http://www.forbes.com/2009/04/17/greenspan-housing-bubble-opinions-contributors-fed.html). For critiques of their view see Robert Higgs, [www.independent.org/blog/?p=1859](http://www.independent.org/blog/?p=1859), and George Selgin, [mises.org/story/3200](http://mises.org/story/3200).
- 9 See Holcombe and Powell, ed., *Housing America: Building Out of a Crisis*. Particularly relevant are Lawrence J. White's "Fannie Mae, Freddie Mac, and Housing: Good Intentions Gone Awry" and Stan J. Liebowitz's "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown."
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- 14 <http://www.propublica.org/special/government-bailouts>

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